

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of George Stevens on April 24, 2006

DATED: July 7, 2006

On April 24, 2006, Michael Schachter and Michael Shapiro, in Willkie Farr & Gallagher LLP's capacity as counsel to the Audit Committee, interviewed former San Diego City Councilmember George Stevens, at the City Administration Building, 202 C Street, in San Diego, in a conference room on the third floor. Johnny Giang and Wendy So from KPMG also attended the interview. Mr. Stevens was not represented by counsel.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with George Stevens, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Mr. Schachter informed Mr. Stevens that we are counsel to the Audit Committee and do not represent him or any employee. He advised Mr. Stevens that the interview may be considered attorney work product and confidential, but the decision of whether to keep it confidential will be made by the Audit Committee in the best interests of the City, not by Mr. Stevens personally. He said that it is important for Mr. Stevens to keep the contents of the interview confidential to maintain the integrity of the process. Mr. Schachter said we will create a report which may contain statements of interviewees, and this report will likely be provided to KPMG and ultimately made public. He said government agencies may view the report and be provided with additional information so it is important to be truthful and accurate. Mr. Stevens asked Mr. Schachter who hired us. Mr. Schachter informed Mr. Stevens that the City of San Diego hired the Audit Committee which in turn hired Willkie Farr & Gallagher LLP. Mr. Giang informed Mr. Stevens that KPMG was retained by the City of San Diego to conduct an audit of the 2003 CAFR.

Background

Mr. Schachter asked Mr. Stevens to discuss his professional background. Mr. Stevens said that he was a Councilmember for eleven years and served three terms, ending on December 3, 2002. He served as Deputy Mayor for three out of the eleven years. Prior to being a Councilmember, he worked for Congressman Jim Bates for eight years and, prior to that, for Supervisor Jim Bates for eight years.

Ron Saathoff & Presidential Leave

Mr. Schachter asked Mr. Stevens to discuss his recollections concerning Ron Saathoff. He responded that he called Saathoff into his office on numerous occasions to learn about the pension system. In his private meetings with Saathoff, he asked Saathoff how enough money was kept in the pension fund in order to pay out benefits. Based on discussions with Saathoff, he came to the conclusion that a high rate of interest had to be obtained. Mr. Stevens said that Ron Saathoff was his "go to guy" to learn about the pension system. He said he thought Saathoff was an "honest individual" and someone upon whom he relied. He relied on Saathoff in part because Saathoff was a fireman and he felt that the police and fire were there for "public protection" and would look out for the public interest. He really thought Saathoff would be truthful. He found out later that that was not the case. Mr. Stevens said that he should have realized that people change. In this context, Mr. Stevens stated that he made some other mistakes while serving on the Council, including allowing the pension funds to be used to pay other expenses and also allowing the creation of the Chargers' ticket guarantee, which caused the City to subsidize the private sector.

Mr. Schachter asked Mr. Stevens about Saathoff's influence at the SDCERS Board. Mr. Stevens responded that Saathoff "ran things" at the SDCERS Board and was the most vocal person. He said "it's obvious" that Saathoff "ran things" and that Saathoff met with Council members and told them about the pension system.

Mr. Schachter asked Mr. Stevens if he recalled the Council providing a benefit to Saathoff in order for him to have the pension fund reduce the trigger. He responded that he did not recall at the time providing a benefit to Saathoff in order for him to have the pension fund reduce the trigger. He said he is not the type of person to give anyone anything unless they earn it. By way of explanation, he said he voted against giving high salaries to City executives and opposed providing purchase of service credits for the head of the Chargers stadium.

Mr. Schachter asked Mr. Stevens why the union heads were receiving Presidential Leave, particularly Saathoff. Mr. Stevens did not recall why the union heads were receiving Presidential Leave. He remembered that there was discussion as to why they should have it but he did not remember the reasons given. Later in the interview, Mr. Stevens said Saathoff needed Presidential Leave because he needed his salary and time off to go to meetings representing the Fire Department. Saathoff's boss was on Saathoff's case about spending too much time negotiating. Mr. Stevens said that unless Saathoff earned a certain number of hours on the job, he would not be eligible for certain benefits.

Mr. Schachter asked Mr. Stevens if he recalled the Council enhancing benefits for the heads of the unions. Mr. Stevens "faintly" recalled enhancing benefits of union heads. The Council did so because if they did not do so, the union heads would not receive the full benefits they deserved.

Meet and Confer

Mr. Stevens was shown Exhibit 1, a Closed Session Meet and Confer Agenda from May 28, 1996, with attachments. Mr. Stevens stated his recollection of events is more clear later on in time.

Mr. Schachter asked Mr. Stevens about his recollection concerning the Meet and Confer process. He responded that he is familiar with Meet and Confer and was opposed to the general process. It was conducted before having a budget and he said that was the "stupidest thing in the world." He said that a budget needs to be developed before people are informed about what they will earn. Mr. Stevens said that overall he did not think the budget "came out right" because San Diego would only receive 17% of sales tax revenues and only 13% of property tax revenues, and the remainder would go to the State. He remarked "you can't run a City that way."

Mr. Stevens was shown Exhibit 2, an April 26, 2002 memorandum from Cathy Lexin and Elmer Heap to the Honorable Mayor and City Council re: "Closed Session Meet and Confer Agenda for April 29, 2002," with attachments including PowerPoint slides. Mr. Stevens questioned whether the PowerPoint presentation came from the City Manager's Office.

Mr. Stevens was shown Exhibit 3, a May 24, 2002 memo from Daniel Kelley (City Labor Relations Manager) to the Honorable Mayor and City Council re: "Final Three Year offer to San Diego Police Officers Association." He did not recall this document.

Mr. Stevens was shown Exhibit 4, a June 14, 2002 memo from Cathy Lexin and Elmer Heap to the Honorable Mayor and City Council re: "Meet and Confer: Contingent Retirement Benefits – Modified Proposal to San Diego City Employees Retirement System Board of Administration." Mr. Schachter asked Mr. Stevens to discuss his involvement with Meet and Confer. He responded that during Meet and Confer, there were a lot of decisions made by the Mayor and City Manager. The Mayor and City Manager would then inform the Council of their decisions in Closed Session.

City Contributions to the Pension Fund

Mr. Schachter asked Mr. Stevens whether he knew that the City contributed to the pension fund and why benefits were increased. He responded that he knew the City contributed to the pension fund. He recalled explanations for increasing benefits such as "it's a wonderful thing to do" and that "we can afford it." He was told that when revenue increased and/or the economy improved, the City would pay in full for the benefits. He assumed the pension fund was "doing great" so the City was able to defer its contributions, and he relied on that assumption.

Mr. Schachter asked Mr. Stevens if he recalled being informed as to why it was necessary for the City to ask the SDCERS Board to reduce its level of contributions. Mr. Stevens did recall, and said that he was told that the City did not get the money from the State that it expected and the economy did not do well. He believed Jack McGrory (City Manager) and Ed Ryan (City Auditor and Comptroller) were involved in these conversations.

Mr. Schachter asked Mr. Stevens if he recalled discussion concerning a "trigger." Mr. Stevens responded that he recalled discussion regarding stopping funding at the actuarial rate in 1996 unless the funding fell to 82%, which would then result in the City going back to the actuarial rate. He said he wondered "Is the money there to do this in the pension fund?" He received "big assurances" that it was there. He was told by Saathoff that "everything would be just fine."

Mr. Schachter asked Mr. Stevens if he recalled a situation involving paying additional benefits to employees but only if the SDCERS Board agreed to relax the trigger. Mr. Stevens responded that he recalled "somewhat" discussions about additional benefits paid to employees only if SDCERS agreed to reduce the trigger but could not recall the outcome.

Mr. Schachter asked Mr. Stevens if he recalled discussions of the City Council regarding paying more retirement benefits in exchange for reducing the City's contribution. He responded that he "faintly" recalled discussions of the City Council regarding paying more retirement benefits if the SDCERS Board reduced the City's obligation. However, Mr. Stevens said he would have had a lot of questions about such a proposal because it would look like "let's make a deal." Mr. Schachter asked if Mr. Stevens recalled that the fiduciary counsel blessed the proposal. He responded that he did not recall fiduciary counsel saying the proposal was improper.

Mr. Schachter asked Mr. Stevens if he heard that the City was giving something to the unions and the City was getting something from the pension fund but that the pension fund was not receiving anything in return. He responded that he did not hear that. He said he would have raised concerns about such an arrangement. Mr. Stevens stated that much later on he gave some thought as to deferring payments, which he termed "stealing" and "putting money somewhere else." He was troubled by the City deferring payments because there was no assurance that the pension fund would be repaid. He said he should have known to raise concerns about this because Chrysler borrowed money from the City, which raised issues in his mind at the time as to the propriety of doing so. He stated that he believed the pension fund should not be used to do other things and he said that the Chrysler situation should have impressed that upon him.

Mr. Schachter asked Mr. Stevens if he recalled being told that the City would only give benefits if the pension board agreed not to have the actuarial rate paid. Mr. Stevens did not recall that.

Mr. Schachter asked Mr. Stevens if he recalled discussions about paying into the pension fund at the actuarial rate. Mr. Stevens said he did not recall an option of paying at the actuarial rate or not paying at such a rate. Mr. Schachter asked Mr. Stevens if he recalled receiving a City Attorney opinion concerning paying into the pension fund at the actuarial rate. He responded that he did not recall receiving a City Attorney opinion about the issue. He said that the City Auditor "okayed" the idea of not paying into the fund at the actuarial rate and remembered the Auditor saying that the City's finances would be "fine."

Corbett

Mr. Schachter asked Mr. Stevens to discuss his recollections regarding Corbett. Mr. Stevens appeared confused and said that he recalled that "the pension fund could pay the liability now." He was unsure whether that was an aspect of Corbett.

Financial Crisis/Pension Crisis

Mr. Schachter asked Mr. Stevens if he could recall any financial crisis in 1996. Mr. Stevens did not recall any particular financial crisis in 1996 and did not notice a tie in between the Republican Convention being held in San Diego and the City's financial problems.

Mr. Schachter asked Mr. Stevens to discuss his recollections concerning the pension crisis. Mr. Stevens stated that the City expected revenues at a certain level and the economy to perform at a certain level and State funding to be at a certain level but each item came in with less money than expected. Once the economy did not get better and the State did not give more money, he felt it was "proper" to take money from the pension system to pay for other items. Later in the interview, Mr. Stevens said "from the start" he was not a supporter of using pension funds to pay other expenses. He recalled his father served in Local 89 and that the money for the union's benefits was taken and used for other things, which came out of the pension fund.

SDCERS Board's Conflicts of Interest

Mr. Schachter asked Mr. Stevens if he was ever concerned about having City employees sit on the pension board. Mr. Stevens responded that he was "all the time concerned" that the City employees sat on the pension board. However, he knew Saathoff was on the Board, thought he would do the right thing, and would influence the Board to protect the fund. He said Saathoff did influence the Board, but influenced it in such a manner as to cause harm to the fund.

Indemnification

Mr. Schachter asked Mr. Stevens if he recalled the City indemnifying the SDCERS Board. He responded that he did not recall the City agreeing to indemnify the CERS Board. Mr. Stevens was shown Exhibit 5, a December 6, 2002 memo from P. Lamont Ewell to the Honorable Mayor and City Council re: "San Diego City Employees' Retirement System (SDCERS) Benefit Enhancements; Response to Public Comment and Correspondence on Items 50 and 51 Adoptions Agenda, Consent Items." He did recall this memo. Mr. Schachter asked Mr. Stevens if the memo refreshed his recollection about the City Council indemnifying the SDCERS Board. He said he did not. He did not recall discussion about the memo but recalled the controversy taking place.

Voting on MP2 and Reactions to Shipione

Mr. Schachter asked Mr. Stevens to discuss how he decided to cast his vote for MP2. He responded that he listened to the discussion and tried to figure out how to vote. He recalled Diann Shipione saying that the fund was not being handled correctly. He voted for MP2 and against Shipione's objections because he talked to Board members who told him they agreed

with his position and because he had no documents to examine. He supported a move to allow deferments by the City because he believed it would not have a negative impact on the pension fund. He said the Saathoff told him it would not have a negative effect and the City Manager said likewise during his presentation. He knew Saathoff and trusted him and did not know Shipione, so he supported Saathoff's view over Shipione's.

Mr. Schachter asked Mr. Stevens what he thought about Shipione at the time. Mr. Stevens responded that he did not know who Shipione was and felt she could have been correct but he had no verification. He read in the newspaper unfavorable things about her and the papers were "never in her favor" so he did not support her. He said he is typically on the side of whistleblowers but only when there is some factual support for what they say and Shipione lacked such factual support.

Blue Ribbon Committee

Mr. Schachter asked Mr. Stevens to discuss his recollections concerning the Blue Ribbon Committee ("BRC"). Mr. Stevens responded that he recalled Mayor Murphy appointing the BRC and that it was something that the Mayor "must do." Mr. Schachter asked Mr. Stevens who headed the BRC, who was Richard Vortmann, and what caused the BRC's findings to be delayed. He responded that he did not recall who headed it, did not recall Richard Vortmann, and did not recall delays in the BRC's findings. He recalled long negotiations about how to fund the Ballpark but did not recall any concerns that the findings of the BRC could impact ballpark financing.

Wastewater

January 29, 2002 Closed Session

Mr. Schachter asked Mr. Stevens if he recalled Dennis Kahlie's January 29, 2002 Closed Session presentation. He responded that he did. However, Mr. Stevens then said that the presentation involved getting deferments from payments that were due, that the federal government was involved, and that the City would have to pay a fine unless they paid on time. He then stated that if the City did not increase the rates, it would have to pay a fine. Mr. Stevens noted that Mayor Golding and Jack McGrory tried to get deferments on the requirement to pay. Later in the interview, Mr. Stevens again recalled Kahlie's presentation and said that he tried to understand why the City had to raise fees on ratepayers. He had no recollection of being told by Kahlie in January 2002 that about \$370 million in grants and loans were at stake. He said he is not a fan of raising rates because it "hurts poor people." He said he supported raising rates for the businesses because low income people had no way to recover the lost income but businesses do. He provided an example of a business charging more for a hamburger to make up the money that would be spent through higher sewer fees, to explain his support for raising rates on businesses but not on low income people.

Kelco

Mr. Schachter asked Mr. Stevens to discuss Kelco and its impact on the rate increases. Mr. Stevens responded that Kelco opposed changes in rates and that they were a big water user and wanted reduced charges. He opposed Kelco's position and could not support

raising rates on the poor. Mr. Stevens remembered Kelco being impacted but he "wasn't going to give them a break." He volunteered that he received political contributions from Kelco but they were small in amount. He would not support an increase in charges for low income people and such an increase did not pass.

Sewer Rate Structure

Mr. Schachter asked Mr. Stevens about his recollections concerning sewer rates and the sewer rate structure. Mr. Stevens responded that he objected to sewer rates being based on water use since such water may be used in the yard and not in the sewer line. He did not recall changes needing to be made to include organics.

COS

Mr. Stevens was shown Exhibit 6, an October 6, 1999 memo from George Loveland to the Honorable Mayor and City Council re: "Water and Sewer Cost of Service Studies." He recalled supporting an increase of rates on businesses and a decrease of rates on individuals.

November 14, 2002 Memo

Mr. Stevens was shown Exhibit 7, a November 14, 2002 memo from Mary Vattimo and Kelly Salt to the Honorable Mayor and City Council re: "Significant Exposure to Litigation: Metropolitan Wastewater Department's Compliance with Federal and State Loan and Grant Guidelines." He vaguely remembered the memo.

Disclosure

Mr. Stevens was shown Exhibit 8, a November 6, 2001 memo from Leslie Girard to the Honorable Mayor and City Council regarding an upcoming Closed Session presentation by outside counsel Bryan Cave LLP regarding disclosure obligations, with attached letter from Bryan Cave LLP to Les Girard re: "Review of Disclosure Documents as to Lease Revenue Bonds 2001." He said that Girard was the Assistant City Manager. Mr. Schachter corrected Mr. Stevens that Girard was the Assistant City Attorney. Mr. Schachter asked Mr. Stevens if he had any recollection of receiving the presentation or of being told to read the Preliminary Official Statement and not rely solely on professionals regarding disclosure. Mr. Stevens responded that he had no specific recollection of a presentation as to the obligations of Council regarding disclosure. He did not recall being told to read the Preliminary Official Statement and not to rely on professionals.

Conclusion

Mr. Schachter asked Mr. Stevens if he had any other information he would like to share with the Audit Committee. Mr. Stevens said that in Closed Session, there were no real minutes taken so it is hard to know what happened and in Meet and Confer no minutes were taken so again it is difficult to know what really happened. At some point, the Council stopped allowing the Clerk to come into the room for Closed Session meetings. He said "how do you

know what was said in Closed Session?" He did not agree with not having the Clerk attend Closed Session meetings.

Mr. Schachter requested that Mr. Stevens keep the contents of the interview confidential to maintain the integrity of the process. Mr. Schachter requested that if Mr. Stevens recalled any information he believes is relevant to our investigation, he should contact us.

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